

## NATIONAL FORECAST DESCRIPTION

### The Forecast Period is the Third Quarter of 1998 to the Fourth Quarter of 2002

After a scare last fall, things appear to have changed in the economy's favor. A review of several indicators shows there are positive signs aplenty. First, real GDP, the most closely watched measure of the nation's overall economic health, grew at a healthy 3.9% annual pace in the third quarter of 1998. It is thought to have advanced by 3.0% in the last quarter of that year. Second, employment has remained strong. The unemployment rate in the third quarter of last year was just 4.5%, which was still about one percentage point below full employment. The number of nonfarm jobs grew at a 2.0% annual rate during this same quarter. Third, the still-strong employment picture has kept consumer confidence high. Fourth, consumer confidence also got a boost from the strong stock market recovery. In fact, last summer's stock market correction proved to be one of history's most fleeting. The S&P 500 index regained its previous peak in just four months. In contrast, it took the market nearly two years to regain its peak after the October 1987 collapse. Fifth, the high level of consumer sentiment and respectable personal income growth has kept consumer spending afloat, and this has kept the economy humming. Sixth, for the first time in nearly 30 years the federal fiscal year ended with a surplus instead of a deficit.

Although it appears that the "Goldilocks economy" has escaped the bears, it is still not out of the woods. The U.S. economy's recent success is in no small part due to the strong consumer confidence that has fueled spending. Thus far, consumer confidence has shown incredible resilience against several attacks, such as last summer's stock market meltdown. However, as the first few years after the 1990-91 recession have taught us, consumers can be fickle. This is no minor detail considering consumer spending accounts for about two-thirds of the nation's economy. Should consumer confidence suddenly go south, it could lead the economy into a recession. (A confidence crisis resulting in a recession is explored in the *Alternative Forecasts* section of this publication.) A less serious problem, but a problem nonetheless, is Japan. While most of the other Asian countries that faced crises have seen their economies stabilize recently, Japan's economy remains a basket case. While steps have been taken to shore up the banking system of Asia's economic engine, only time will tell if these moves will successfully restart Japan's economy. Any meaningful Asian recovery must include Japan. The fear is that a continued Japanese malaise may cause other economic problems that will eventually spread to our shores.

The current forecast assumes the "Goldilocks economy" will avoid most traps. Therefore, no recession is anticipated over the forecast period. That is not to say the next few years will be a breeze. The U.S. economy will have its closest brush with a recession in 1999. Continuing problems in Asia will find their way to the U.S. Asian countries will look to the U.S. in an effort to export their way out of their current economic slumps. While U.S. consumers will benefit from lower import prices, the wave of imports is expected to eventually cost some Americans their jobs. This is especially noticeable in 1999, when U.S. nonfarm growth drops to around one percent and the unemployment rate begins its gradual rise. This will cause consumer confidence to decline, but this is expected to be an orderly retreat. Over this period, consumer spending will slow to about the pace of real disposable income growth. While this is lower than in recent years, it is a sustainable pace that should keep the U.S. economy moving forward.

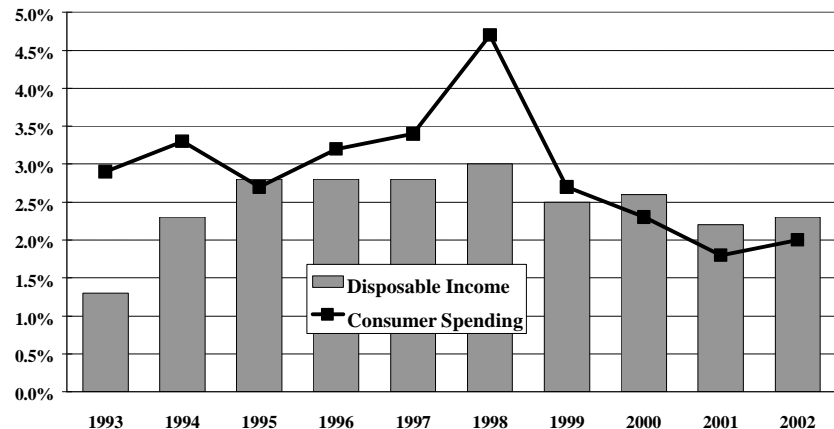
## SELECTED NATIONAL ECONOMIC INDICATORS

**Consumer Spending:** Real consumer spending growth should slow over the forecast period. Indeed, some of this slowing has already taken place. During the first half of 1998, real consumer spending advanced at a 6.1% annual rate. Preliminary data for the third quarter show that this measure slowed

markedly to about 4.0%. Real consumer spending is forecast to slow further to 3.0% by the last quarter of 1998. Several of the factors contributing to this slowing will continue to limit future real consumer spending growth. First, consumer confidence has slipped. As measured by the University of Michigan's Index of Consumer Sentiment, October 1998 consumer confidence had retreated 13 points from its all-time high in February 1998. Confidence is expected to decline slowly over the forecast period as the unemployment rate inches upward. Indeed, in recent surveys

consumers have remained generally upbeat about current conditions but have expressed more anxiety about a softening job market down the road. Second, despite the recent slide in consumer confidence, consumers have been willing to take on more debt. After remaining stable for two years, nonmortgage consumer credit measured relative to disposable income rose steadily last year, hitting a record 21.2% in September 1998. Near-record low interest rates no doubt induced consumers to take on more debt. However, it is unlikely it can remain at that level, especially given the outlook of falling consumer confidence. Third, consumers will need to rebuild dismally low savings. In 1998 the savings rate is expected to average under 0.5%. In September of that year the savings rate was negative. Part of the explanation for this weakness is the steady ascent of the stock market. With household net worth at an all-time high, consumers apparently feel the stock market is doing their saving for them, allowing them to spend more freely out of current income. However, households' net worth gains are expected to grow slower in the future, as stock market gains are projected slow from double-digit rates to single-digit rates. Given these factors, it appears that real consumer spending will grow about as fast as real disposable income. The good news is that income growth should be relatively healthy. Specifically, national real disposable income should rise 3.0% in 1998, 2.5% in 1999, 2.6% in 2000, 2.2% in 2001, and 2.3% in 2002. Real consumer spending should rise 4.7% in 1998, 2.7% in 1999, 2.3% in 2000, 1.8% in 2001, and 2.0% in 2002.

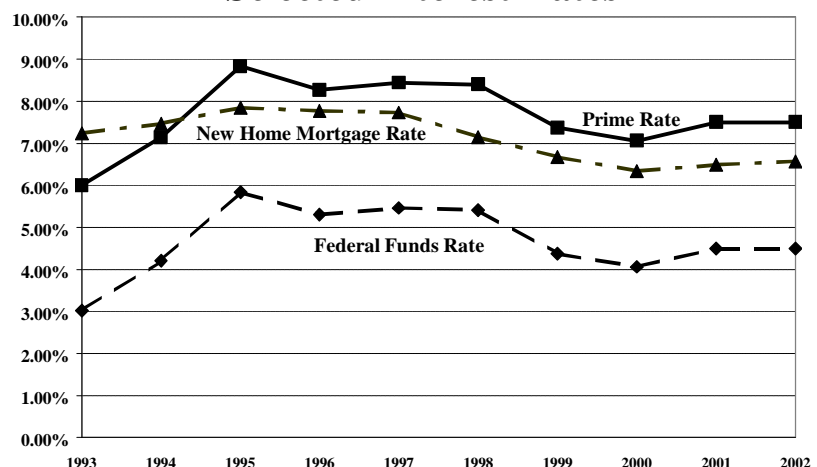
## Real Spending & Real Income Growth



Source: Standard and Poor's DRI

**Financial:** The Federal Reserve loosened aggressively in the fall of 1998 in an effort to keep the current expansion moving ahead. Over the six-week period from the end of September 1998 to mid-November 1998, the nation's central bank dropped its bellwether federal funds rate target from 5.5% to 4.75%. The discount rate was dropped from 5.0% to 4.5%. More cuts are likely. With inflation stable, the Federal Reserve has been afforded more wiggle room to lower rates further

## Selected Interest Rates



Source: Standard and Poor's DRI

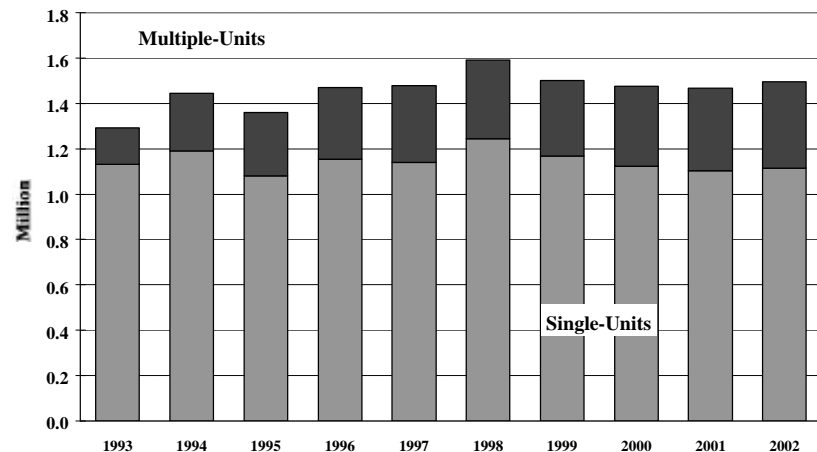
and help to insure the economy continues to grow. The stock market seems to be backing away from its fears of a recession, but growth is expected to be very low in early 1999. In this forecast it is assumed the Federal Reserve will ease further. However, this seems unlikely given the Federal Reserve did not raise rates in December 1998. It appears that the nation's central bank is content that the economy has dodged a downturn. Thus, it is more willing to take a wait-and-see policy. However, the economy will be vulnerable to a recession this year, so another round of loosening by the Federal Reserve in the near future is not entirely out of the question.

**Housing:** The nation's housing industry should remain one of the economy's strongest performers over the forecast period. Housing starts rose to 1.64 million units in the third quarter of 1998, its strongest quarterly showing since 1987. Housing sales were also strong. In the third quarter of 1998, new home sales (842,000) had their third strongest quarter ever. In addition, existing home sales in that same quarter were the second highest on record. This strong showing is primarily due to the strong job market and the increasing affordability of homes.

The strong job market has bolstered consumer confidence, which has led more Americans to take the plunge and purchase homes. Thanks to low interest rates and steady income growth, the affordability of owning a home has increased tremendously over the last two decades. To put this in perspective, in the early 1980s the after-tax cost of owning a home was roughly half of household disposable income. By 1998, this was slashed almost in half, so that housing cost was approximately a fourth of household disposable income. This has helped the home ownership rate rise to record levels. The U.S. Census Bureau reported that the third quarter 1998 home ownership rate was nearly 67.0%, its highest level since it started collecting this information in 1956. Home ownership rates had been stagnant for nearly two decades, at around 62-64% before 1994, when they started to rise. The falling mortgage interest rates that have been a boon to housing affordability have also benefited existing homeowners. In mid-October 1998, the Mortgage Bankers Association reported that more than 60% of the new loan applications were for refinancing, which was up from 40% a year earlier. This should lower consumers' home payments and free up cash that can be used for other things, such as consumer spending. The nation's housing industry also benefited from the overall strength of the economy and the stock market. As these cool from their recent robust paces, so will the housing industry. However, it should be stressed that the projected decline in housing starts will be gradual. Specifically, U.S. housing starts are expected to go from 1.59 million in 1998 to 1.50 million in 1999, 1.48 million in 2000, 1.47 million in 2001, and 1.50 million in 2002.

**International:** The Asian crisis dominated much of the economic news last year. This forecast notes there is some good news to report, but some serious problems still need to be addressed. First, the good news. The Asian economies are beginning to show signs of bottoming out. Exchange rates, with the exception of the Indonesian rupiah, have been stable since the spring of 1998. Stock markets in most of the countries affected by the currency crises are beginning to rebound. The flight of capital from Asia is

## U.S. Housing Starts

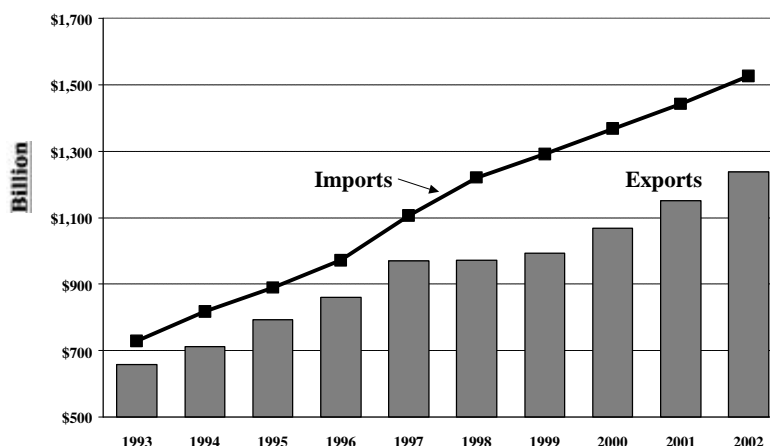


Source: Standard and Poor's DRI

at least moderating. Despite this good news, Japan remains in economic doldrums. Asia's largest economy is currently in its longest down cycle since the great depression. This engine of Asian economic growth is not just stalled, but in need of an overhaul. Until the Japanese banking system is fixed, it is not likely that it will experience a sustained recovery. Even Japan's most recent steps to get its economic house in order do not go far enough. The new bank-bailout bill makes a first step toward fixing the financial system, but it is too small to solve the

problem and still avoids tackling the disposal of bad loans and other assets. There is good reason for Japanese politicians to put off the economic day of reckoning as long as possible: the cure will be painful. The Japanese problem is far greater than the U.S. savings and loan crises. At the worst of the U.S. savings and loan problems, nonperforming loans were about 3.0% of U.S. GDP. In comparison, it has been estimated that nonperforming bank loans are 30.0% of Japanese GDP. Unfortunately, the story gets worse. On top of these loans are other nonperforming loans that could double this ratio. The Japanese recession is therefore likely to persist into 2000, and even longer if the Japanese Diet fails to make the needed reforms.

### U.S. Imports and Exports



Source: Standard & Poor's DRI

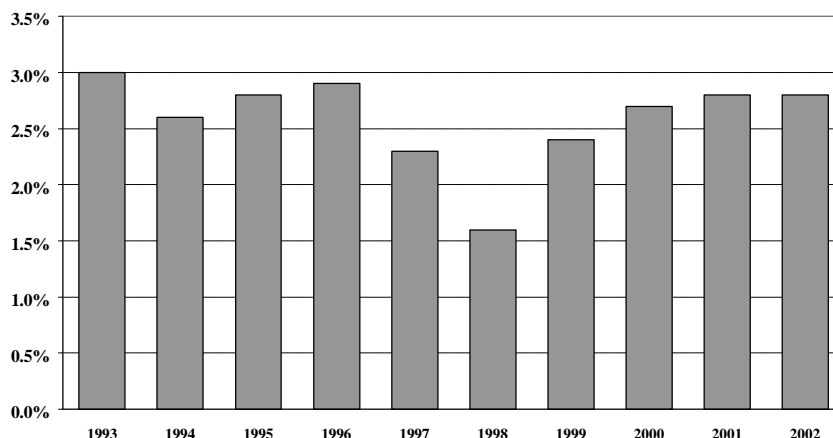
**Government:** The federal budget is expected to remain in surplus during the forecast period. The federal fiscal year ended with a \$70 billion surplus, the first since 1969. This was a pleasant surprise. President Clinton's original budget, which was submitted in February 1997, projected a \$10 billion deficit for that year. By the time fiscal year 1998 began, the projected deficit had been raised to nearly \$60 billion. The nearly \$130-billion swing between the start and end of the fiscal year resulted from a 5.5% underestimate of revenues and a 2.3% overestimate of outlays. Overall, federal receipts climbed 9.0% in fiscal year 1998, while federal outlays rose just 3.0%. The strong receipts were due in large part to the continued strength of the job and stock markets, which helped personal tax collections swell 12.4% in fiscal year 1998. The major surprise on the outlay side was Medicare spending, which increased just 1.5% after a decade of relentless 10% annual increases. It is assumed that much of the future federal budget surpluses will be used to pay down debt. However, some of the surpluses will be used to finance other projects. For example, this forecast assumes there will be some modest tax cuts before the 2000 election. It should also be pointed out that while the federal budget is projected to remain in surplus over the forecast period, there will be some slippage as economic growth slows and capital gain realizations shrink. However, the surplus does rebound in 2002. Specifically, the federal surplus (on a unified budget basis) is projected at \$63.3 billion in 1999, \$42.8 billion in 2000, \$31.0 billion in 2001, and \$63.7 billion in 2002.

**Inflation:** Inflation should remain mild despite an anticipated acceleration in employment costs. The Employment Cost Index for Compensation (wages, salaries, and benefits) has risen slowly in recent years, despite an ever-tightening labor market that dropped the unemployment rate below the full employment level. However, employment costs did start to heat up last year, growing 3.6% compared to 1997's 3.1%. Ordinarily this would cause consumer inflation to pick up speed. However, the opposite has occurred recently. In late 1998 it was estimated that the consumer price index had advanced just 1.6%

that year. In comparison, inflation in 1997 was significantly higher at 2.3%. The difference between the two can be traced to the energy and food components of the consumer price index. In 1997, energy prices rose 1.2%. Energy prices collapsed nearly 8.0% in 1998 due to soft world demand. For example, the price of West Texas Intermediate crude oil in October 1998 was just two-thirds of its price of the previous October. Food prices rose 2.6% in 1997, but just 2.1% in 1998. These changes in energy and food prices were able to push overall inflation

below 2.0% for the first time since 1986. It should be kept in mind that both energy and food prices are notoriously volatile, and they are not expected to remain low. In fact, the current forecast calls for these prices to ramp up slowly over the forecast period. Despite this, inflation should remain below 3.0%. One of the reasons for this is because while the U.S. labor market is tight, manufacturing capacity is relatively slack. Manufacturing utilization in the U.S. is about 80% of capacity, which is safely below the 83-85% that is associated with accelerating inflation. Of course, this only relates to U.S. manufacturing. Given the slowdown in Asia, there is even more slack capacity worldwide, especially for certain types of industries. Consumer price inflation, as measured by the consumer price index for all urban consumers, is projected to be 1.6% in 1998, 2.4% in 1999, 2.7% in 2000, 2.8% in 2001, and 2.8% in 2002.

## Consumer Price Inflation

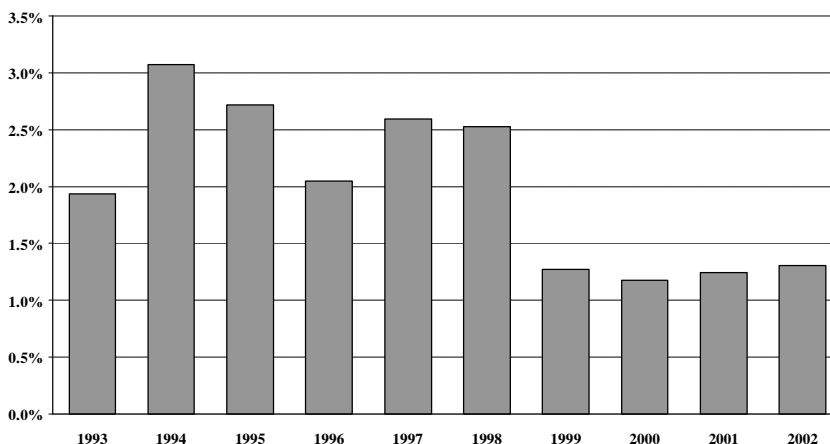


Source: Standard and Poor's DRI

**Employment:** The U.S. labor market is expected to loosen over the forecast period after posting another impressive showing in 1998. Last year, the number of jobs in the U.S. rose an impressive 2.5%, virtually matching 1997's strong gain. It also marked the fifth consecutive year that the number of jobs has expanded by more than 2.0%. This job expansion has caused the U.S. civilian unemployment rate to fall to levels that a few years ago were considered unattainable. For example, as recently as 1993 the civilian unemployment rate was

6.9%, which was well above the 5.3% economists considered full employment. As the economy shook off the effects of the 1990-91 recession, the once stubbornly high unemployment rate declined steadily, so that by 1996 the economy was essentially at full employment. However, this was not employment's zenith; labor markets continued to tighten after that year. In 1997, the unemployment rate actually fell one-half percentage point below the full employment threshold. In 1998, it was almost a full percentage

## U.S. Nonfarm Employment Growth



Source: Standard and Poor's DRI

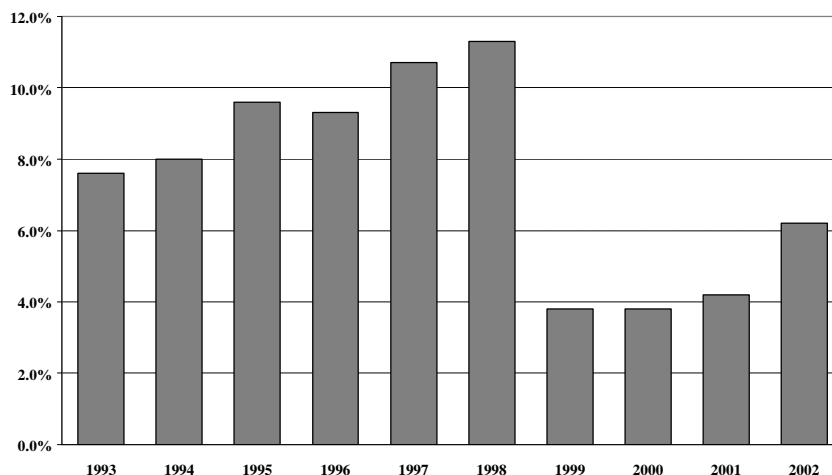
point below full employment. Of course, this is not expected to continue indefinitely. Over the next few years the U.S. economic growth is forecast to slow and so is employment. Nonfarm job growth in the U.S. is anticipated to slow to 1.3% in 1999, 1.2% in 2000, 1.2% in 2001, and 1.3% in 2002. The U.S. civilian unemployment rate is expected to rise gradually over this same period, going from a low of 4.5% in 1998 to 5.4% in 2002. Keep in mind that although labor markets are expected to slacken, the civilian unemployment rate should remain below the 5.5% full-employment rate. In other words, after several years of unusual tightness, labor markets should gradually return to more normal levels.

## Production and Business

**Investment:** The slowing national economy will exact a toll on industrial production and business investment. After posting three-straight years of growth above 3.0% from 1996 through 1998, real GDP is forecast to advance by just 1.7% in 1999. Not surprisingly, U.S. industrial production should also experience a noticeable slowdown. The current forecast shows this measure's growth dropping from 1998's 3.1% to 1.3% in 1999. After 1999, industrial production should recover, advancing 2.8% in

2000, 2.5% in 2001, and 3.5% in 2002. After the current soft landing, manufacturing output will rebound with 3.0% growth in 2000 and average 3.2% gains from 2000 to 2003. That is weaker than the 4.5% average of the previous four years, but slightly higher than the average for the past 20 years. Although production growth will be respectable across the manufacturing sectors, operating rates will slip under 80% in the near term before stabilizing. The good news is that this is well below the inflationary threshold. The down side to this is that the lower operating rate will dampen the need for new investment. As a result, real nonresidential fixed investment, which had grown at double-digit rates in both 1997 and 1998, should slow to less than 4.0% growth in both 1999 and 2000. Real producers' durable equipment, which had expanded nearly 17.0% last year, should advance just 6.5% in 1999 and 4.7% in 2000. Real investment in nonresidential structures is hit even harder than producers' durable equipment spending. Real nonresidential structure investment is expected to have declined 1.6% in 1998 and should fall another 3.8% in 1999. The outlooks for both of these sectors should improve slowly after 1999. Overall, real nonresidential fixed investment is forecast to rise 11.3% in 1998, 3.8% in both 1999 and 2000, 4.2% in 2001, and 6.2% in 2002. It should be noted that the economy has made a smooth transition to lower inventory growth. Inventories accumulated at an unsustainable fast pace during the first part of 1998. This raised fears that a strong inventory correction would follow. While inventory growth did taper off, it did it in an orderly manner and the economy was spared the pain of a severe inventory correction.

**Real Business Investment Growth**



Source: Standard and Poor's DRI